FILED
JUN 13 1994
OFFICE OF THE CLERK

(9)

No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

BRIEF OF RESPONDENT

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SUMMARY OF ARGUMENT

Congress has determined that obligations of the federal government are exempt from taxation by the states. This Court has held the exemption is "sweeping" and extends to every form of state taxation which requires that such obligations or the interest thereon be considered in calculating the tax. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983). Respondent, through mutual funds, earned interest on federal obligations which are subject to repurchase agreements. The State of Nebraska impermissibly sought to tax this income and the Nebraska Supreme Court properly declared the Nebraska revenue rule at issue invalid.

The mutual funds in which respondent owns shares invest in federal obligations through the use of repurchase agreements to lock in a specified rate of return for a short term investment without running the risk that a change in interest rates will cause them to lose not only their interest earnings but part of their capital. In every other respect, the mutual funds' purchases of federal obligations are identical to purchases by investors who have not chosen to use repurchase agreements. The repurchase agreements are structured as purchases and sales for valid business reasons unrelated to tax issues. The structure of the transactions chosen by the parties should be respected.

If the Nebraska revenue ruling is not invalidated, petitioner will be permitted to tax part or even all of the interest income generated by federal obligations held by Nebraskans in violation of 31 U.S.C. § 3124 (1988) and the Supremacy Clause, U.S. Const. art. VI. Not only is there

no "double tax benefit" under this revenue ruling; if petitioner's position is upheld, no one will obtain the complete benefit of the exemption of interest on federal obligations from state taxation mandated by Congress. In addition, since the tax is imposed only on federal obligations that are subject to repurchase agreements but not upon similar state obligations, Nebraska impermissibly discriminates against the holders of federal obligations.

The determination of whether a state tax on federal obligations is invalid involves a two step process. First, the court must determine whether Congress has prohibited the states from imposing such a tax. Second, if the tax is not barred by statute, the court must determine "whether the constitutional doctrine of intergovernmental tax immunity requires any broader exemption." *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 188 (1987). This brief will demonstrate that the Nebraska income tax which petitioner seeks to impose on respondent is invalid under both tests.

ARGUMENT

I. CONGRESS DID NOT INTEND TO PERMIT STATES TO TAX INCOME DERIVED FROM FEDERAL OBLIGATIONS SUBJECT TO REPURCHASE AGREEMENTS.

A. Repurchase Agreements are Merely a Way for Multiple Taxpayers to Share Income Exempt from State Taxation.

Perhaps the easiest way to understand repurchase agreements conceptually is to think of them as the

securities equivalent of real property time share agreements. A series of investors each own the same federal obligation for a limited number of days and divide among themselves the interest paid by the federal government.

Consider a situation in which thirteen investors are each willing to loan the federal government $10,000 for a different thirty consecutive day period. A dealer in federal obligations initially purchases a treasury bill for $9,740 at a treasury auction[1] and immediately sells it to Investor A for $9,740 with an agreement to repurchase it thirty days later for $9,769. After thirty days, the dealer

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[1] The authority to issue treasury bills is found at 31 U.S.C. § 3104 (1988). The hypothetical price of $9,740 was chosen to provide for $360 in interest, or $1 per day, to allow for simplicity in calculations. A leading authority explains treasury bills, or T bills, as follows:

> T bills bear no interest. An investor in bills earns a return because bills are issued at a discount from face value and redeemed by the Treasury at maturity for face value. The amount of the discount at which investors buy bills and the length of time bills have to be held before they mature together imply some specific yield that the bill will return if held to maturity. T bills are currently issued in 3-month, 6-month, and 1-year maturities. In issuing bills, the Treasury does not set the amount of the discount. Instead, the Federal Reserve auctions off each new bill issue to investors and dealers, with the bills going to those bidders offering the highest price, that is, the lowest interest cost to the Treasury. By auctioning new bill issues, the Treasury lets currently prevailing market conditions establish the yield at which each new issue is sold.

M. Stigum, *The Repo and Reverse Markets* (1989) 14.

repurchases the security as agreed[2] and then sells it to Investor B with an agreement to repurchase it thirty days later for the sale price plus $29, again earning $1.00. This process is continued throughout the year. By the end of the year, there would be thirteen investors who had each earned $29 in income exempt from state taxation and the dealer would have earned $13 in income exempt from state taxation.[3]

Thus, the parties have devised a way in which to collectively purchase a federal obligation which none of them individually would have been able to purchase and hold to maturity and they have allocated among themselves the total interest paid by the federal government which is exempt from state taxation. It is this interest income from federal obligations which petitioner improperly sought to tax.

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[2] During this thirty day period, the federal obligation would earn $1 a day or $30 in interest. However, the purchaser of the security pursuant to the repurchase agreement typically earns slightly less than the earnings on the underlying instrument. The additional dollar is the dealer's profit on the transaction.

[3] Note that the economic substance of these transactions is that the thirteen individuals have collectively provided $10,000 to the federal government to finance the national debt while the dealer provided services but *no* funds of its own. Yet petitioner argues that *none* of the exempt interest should be allocated to the thirteen individuals who provided *all* of the funds. Petitioner's Brief at 32. Clearly, such an approach would not reflect the economic substance of the transaction.

B. Congress Intended the Exemption of Federal Obligations From State Taxation to be Broad and Sweeping.

Prior to 1959 there existed a "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests. . . ." *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858 (1983). However, in 1959 Congress amended the applicable statute, "set aside this Court's rather formalistic pre-1959 approach," and adopted a "sweeping" exemption for federal obligations. 463 U.S. at 862. Congress decreed that "[t]he exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax." 31 U.S.C. § 3124(a) (1988). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its form if federal obligations must be considered, either directly or indirectly, in computing the tax." 463 U.S. at 862.

Under the statute, "considered" means "taken into account or included in the accounting." *Id.* The issue, therefore, is not the formal one of determining who "owns" the government obligations that are the subject of a repurchase agreement. Rather, the question is whether taxation of the mutual funds' income from purchasing and selling federal obligations subject to repurchase agreements is a form of taxation that requires that the obligations, the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. Clearly, taxation of respondent's income earned by the mutual funds through buying and

selling federal obligations requires that the federal obligations be "considered, either directly or indirectly, in computing the tax." *Id.* The prohibition of taxing federal obligations is therefore violated.[4]

C. State Taxation of Income Earned Under Repurchase Agreements Which Requires That Federal Obligations be Considered Violates 31 U.S.C. § 3124 (1988).

The mutual funds in this case earn no income when they first enter into a repurchase agreement. Indeed, all that occurs is that the mutual funds transfer cash to the seller and the federal obligations are transferred to a custodian for the mutual funds (J.A. 62-63, ¶¶ 10-13). The mutual funds only recognize income at the conclusion of the transaction. This occurs in one of two ways. If the seller defaults and fails to repurchase the federal obligations, the mutual funds sell those obligations with the intention of recovering the original purchase price plus

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[4] The taxable character of respondent's income as a mutual fund shareholder is the same as its character in the hands of the mutual funds. By statute, respondent is entitled to subtract "that portion of the total dividends and other income received from a regulated investment company which is attributable to obligations described in subdivision (a) [obligations exempt from state income taxes] of this subsection as reported to the recipient by the regulated investment company." *Neb. Rev. Stat.* § 77-2716(1)(b) (1993). Thus, the Nebraska Supreme Court did not consider the question of whether such a "pass-through" of tax exempt status is required by either 31 U.S.C. § 3124 (1988) or the Supremacy Clause. Accordingly, contrary to the argument of the amici curiae State of California *et al.* at p. 17 of their brief, this issue is not before this Court. 28 U.S.C. § 1257(a) (1988).

the agreed upon interest. At this point the mutual funds would clearly have realized income requiring consideration of "either the obligations or the interest thereon, or both" which would be exempt from taxation by the State.

The other, and presumably more common alternative, is for the original seller to carry out its obligations and repurchase the government obligations at the agreed-upon price. (J.A. 63, ¶ 18). The mutual funds' profit on this resale reflects income earned by them in consideration of their holding of government obligations just as surely as the income they would receive in the first instance in the event of a default. *In either event the mutual funds recognize no income until they transfer the government obligations.* The economic reality is that whatever income the mutual funds derive from these transactions arises in consideration of the federal obligations that are the subject of the transaction. As a result that income must be exempt from taxation by the State of Nebraska.

D. Semantic Distinctions Without a Difference Should Not Change the Tax Result.

Petitioner argues that the federal obligations and the interest on them are not "considered" in repurchase transactions by advancing a number of semantic distinctions that make no difference.

1. Taxpayers earning exempt income need not receive a check directly from the federal government.

Petitioner argues that a party to a repurchase transaction does not receive a check from the federal

government labeled interest: therefore that investor cannot have exempt income. A federal obligation may change hands dozens of times between interest payments or before it matures. The interest earned by the obligation over its life, or between interest payment dates, is distributed ratably among the various parties based on the number of days they held the obligation.[5] If the rule were otherwise, parties could avoid paying any state income tax whatsoever by simply buying federal obligations the day before they matured or an interest payment was due and then claiming an exemption for all of the interest paid on that date, even though the party had only owned the obligation for one day. Thus, parties to repurchase transactions are no different than other investors who trade federal obligations and earn tax-exempt income, even though they never receive a check from the federal government.

2. An investor's rate of return is determined by the market, not by the nominal rate on the face of the obligation.

Next, petitioner argues that repurchase transactions are somehow different from other purchases of federal obligations because the rate of return which an investor earns differs from the nominal interest rate on the face of the obligation. But, again, the same is true of all investors in federal obligations.[6] The nominal rate of interest on a

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[5] I.R.C. §§ 1271 and 1276.

[6] The only exception would be an investor who buys an obligation at par and holds it to maturity.

treasury note or bond affects an investor's rate of return only indirectly.[7] For example, if current rates on new issue four year $1,000 notes are 8.5%, but an investor finds a six month old outstanding similar obligation bearing 8% nominal interest, the investor will be able to buy the 8% note for $985.13.[8] Both obligations, either the new issue purchased for $1,000 or the outstanding issue purchased for $985.13, would yield an investor 8.5% to maturity. The investor's rate of return is determined by current market interest rates, not by the nominal rate on

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[7] Notes are authorized by 31 U.S.C. § 3102 (1988); bonds by 31 U.S.C. § 3103 (1988). Like the yield on treasury bills, the yield on notes and bonds is also determined by auction.

> The Treasury also issues interest-bearing *notes*. These securities are issued at or very near face value and redeemed at face value. Notes have an *original maturity* (maturity at issue) of 2 to 10 years. Currently, the Treasury issues 2-, 3-, 4-, 5-, 7-, and 10-year notes on a regular cycle. Notes of other maturities are issued periodically depending on the Treasury's needs. Interest on Treasury notes is paid semiannually. Notes, like bills, are sold through auctions held by the Federal Reserve. In these auctions participants bid yields, and the securities offered are sold to those dealers and investors who bid the lowest yields, that is, the lowest interest cost to the Treasury. Thus, the coupon rate on new Treasury notes, like the yield on bills, is determined by the market. . . .
>
> In addition to notes, the Treasury issues interest-bearing negotiable *bonds* that have a maturity at issue of 10 years or more. The only difference between Treasury notes and bonds is that bonds are issued in longer maturities.

Stigum, *supra*, at 14.

[8] Stigum, *supra*, at 45-46.

the face of the federal obligation, and this is true whether or not a repurchase agreement is involved.

3. "Market Risk" is not required by the statute.

Finally, petitioner argues that the interest earned by holders of federal obligations subject to repurchase agreements should not be exempt from state taxation because they are not subject to any market risk. Petitioner offers no explanation why exposure to market risk should be the *quid pro quo* that a taxpayer must bear to have tax-exempt income. Congress certainly did not include the words "own" or "ownership" or any similar concept in 31 U.S.C. § 3124(a) (1988).[9]

The statute focuses on the obligation or interest earned by the obligation. In other words, the "price" paid by the federal government for the use of the investor's funds is exempt from taxation regardless of who receives it or how they receive it. The concept of "ownership" is simply not an issue under 31 U.S.C. § 3124.

Parties to all kinds of commercial transactions take steps to limit their exposure to market risk without changing their tax status. The owner of a stock can buy an option giving the owner the right to sell the stock at a

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[9] Title 31, U.S.C. § 3124(a) (1988), provides that:
Stocks and Obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

specific price even if the market price should drop. The owner of real estate who sells his property can continue to take interest and depreciation deductions right up to the day of closing even though he is no longer effectively subject to market risk once the purchase agreement is signed. There is simply no reason for this Court to imply a "market risk" requirement when Congress has not seen fit to explicitly impose one.

E. The Nebraska Supreme Court Correctly Held That Income Earned from Federal Obligations Subject to Repurchase Agreements is Exempt from State Taxation.

Congress adopted a broad and sweeping exemption for earnings from federal obligations in 1959. In doing so, it expressly rejected arbitrary semantic distinctions. This Court should reject the petitioner's suggestion that the exemption of income earned by federal obligations from state taxation should again be determined by applying meaningless labels or pigeonholing transactions. Interest earned by federal obligations which are the subject of repurchase transactions is interest the taxation of which requires that federal obligations be considered either directly or indirectly. Congress has explicitly, clearly, and definitively indicated that it intends such income to be exempt from taxation by the states. The Nebraska Supreme Court therefore correctly determined that Revenue Ruling 22-85-1 violated 31 U.S.C. § 3124 (1988) and this Court should affirm that decision.

II. THE ALLOCATION OF RIGHTS, DUTIES, AND ECONOMIC RESULTS BY THE PARTIES TO A TRANSACTION HAVING ECONOMIC SUBSTANCE INDEPENDENT OF TAX CONSIDERATIONS SHOULD BE HONORED BY TAX AUTHORITIES.

A. Parties are Free to Structure a Transaction to Meet Individual Needs Without Government Interference.

The parties to a repurchase agreement have explicitly agreed that one party will buy and another party will sell specifically identified securities at a mutually agreed upon price. Pursuant to the agreement, a notation is made on the book-entry system of the Federal Reserve transferring ownership of the specific securities involved from the seller to the buyer. Courts should not interfere with the structure of transactions chosen by taxpayers when "the Government is likely to lose little revenue, if any, as a result of the shape given the transaction by the parties," especially when "[n]o deduction was created that [was] not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently." *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). The petitioner's purpose in adopting the challenged revenue ruling was to try to reach income that would otherwise be tax exempt, thereby increasing its revenues at the expense of the federal government and taxpayers investing in federal obligations. The petitioner has not and cannot meet the standards announced by this Court that would allow petitioner to recharacterize this transaction to suit its own revenue enhancing purposes.

In *Frank Lyon Co.*, this Court upheld the taxpayer's characterization of a sale-leaseback transaction because the structure of the transaction was determined primarily by business and regulatory factors and not tax avoidance. The Court announced the following rule:

> [W]e hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties

435 U.S. at 583-84. Thus, even though "none of the parties to this sale-and-leaseback was the owner of the building in any simple sense," 435 U.S. at 581, the taxpayer was entitled to depreciation deductions as the "owner" of the building because that was how the transaction had been structured for business and economic reasons independent of tax considerations.[10] Courts have subsequently recognized that the "substance over form" argument

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[10] The Court recognized that a party may properly take tax considerations into account, as long as tax avoidance is not the sole motive of the structure of the transaction: "The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." 435 U.S. at 580.

advanced by petitioner in this case has a very restricted role.[11]

> The substance over form or economic reality argument is not a broad legal doctrine designed to distinguish between legitimate and illegitimate transactions and employed at the discretion of the tax court whenever it feels that a taxpayer is taking advantage of the tax laws to produce a favorable result for the taxpayer. . . . In general, absent specific congressional intent to the contrary, . . . , a court cannot disregard a transaction in the name of economic reality and substance over form absent a finding of sham or lack of business purpose under the relevant tax statute.

Humana, Inc. v. Commission, 881 F.2d 247, 254-55 (6th Cir. 1989).

Courts have generally construed *Frank Lyon Co.* as mandating that a transaction be examined from two perspectives. "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc. v. Commission*, 752 F.2d 89, 91 (4th Cir. 1985). Another court has phrased the issue thusly:

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[11] This Court rejected the argument by the government for a "rule calling for a realistic approach to tax situations" because "so broad and unchallenged a principle furnishes only a general direction, [and] . . . is of little value in the solution of tax problems." *Higgins v. Smith*, 308 U.S. 473, 476 (1940).

> In determining whether a transaction is a sham, courts typically focus on two related factors: 1) has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance? 2) Has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?

Bail Bonds by Marvin Nelson, Inc. v. Commission, 820 F.2d 1543, 1549 (9th Cir. 1987).

Focusing on these two factors does not imply "a rigid two-step analysis. Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses." *Sochin v. Commission*, 843 F.2d 351, 354 (9th Cir. 1988). A precise formulation of the test is not determinative in this case. Regardless of how a repurchase transaction is viewed, the parties are motivated by business and regulatory concerns that are independent of tax considerations. Therefore, there is no authority for the petitioner's attempt to recharacterize repurchase agreements as something other than the transaction which the parties themselves formulated.

B. Repurchase Agreements are Structured By Investors as Sales for Valid Business Reasons.

The use of repurchase agreements evolved for reasons totally unrelated to tax considerations.[12] Federal securities offer investors numerous advantages. First, there is almost no default risk. Second, they are traded in large numbers and thus highly liquid. Third, they are widely available in a variety of denominations and maturity dates. Thus federal securities are an ideal choice for long-term investors who are seeking a safe investment offering a reasonable rate of return.[13]

However, federal securities have one chief disadvantage as short-term, i.e., several day, investments. Investors who have funds they know they will need within a few days run a risk that they will actually lose money if they buy federal securities. Unlike an investor putting money in a checking or savings account or certificate of deposit, a purchaser of federal securities is not certain to obtain all of the investor's money back if the security must be sold prior to maturity.

The following illustration demonstrates this point. Assume that a corporate or municipal treasurer has $9.5 million in cash on Tuesday that will be needed to pay bills due on Friday. If the current rate of interest on twelve month treasury bills was approximately 5.25%, the

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[12] Indeed, a significant number of participants in the repurchase market are entities such as cities and states which pay no income tax. Stigum, *supra*, at 113.

[13] Stigum, *supra*, at 15.

treasurer could buy securities worth $10 million at maturity for $9.5 million when they were issued on Tuesday[14] and resell them on Friday for $9,504,166, earning the company or municipality $4,166 in the process.[15] However, if in the intervening three days the Federal Reserve raises interest rates on comparable securities to 5.5%, then on Friday when the securities were sold, they would be worth only $9,483,017, resulting in a net loss of $16,983.[16]

Although a sophisticated securities trader might be willing to risk such a loss for the specified return, the treasurer of a conservative corporation or municipality would not.[17] Repurchase agreements evolved, from an investor's point of view, for the purpose of avoiding this interest rate risk.[18] If an investor could simultaneously

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[14] $9,500,000 x 5.26315% (actual interest rate) = $500,000 interest + purchase price = $10,000,000 value at maturity.

[15] $9,500,000 x 5.26315% ÷ 360 days in a year x 3 days = $4,166.66.

[16] $10,000,000 value at maturity ÷ 1.055 (1 plus rate of interest) = $9,478,672.90 + 3 days interest at 5.5% ($4,344.39) = $9,483,017.20.

[17] A sophisticated investor could also guard against market risk by purchasing a security and then separately purchasing a put (a right to sell the security at a specified time at a specified price) without foregoing the right to tax exempt interest. Rev. Rul. 82-144, 1982-2 C.B. 34. That is essentially what a repurchase agreement is.

[18] This problem of interest rate risk is unique to short-term investors. The long-term investor can simply hold the security to maturity and then receive back the face amount of the instrument without incurring any capital loss. But for any party needing its money before the instrument matures, there is always a risk of getting back less than was initially invested.

agree to purchase the securities for $9.5 million on Tuesday and to resell them on Friday for an additional $4,156, the investor would have locked in a reasonable rate of return and avoided the possibility of an actual capital loss. Repurchase agreements are designed to achieve exactly this result.

Petitioner contends that the price a prudent investor in federal obligations must pay for this protection against interest rate risk is the loss of the exemption from state taxation of the interest income earned on this investment. But the petitioner offers no principled reason why an investor who wants to invest in federal obligations on a short-term basis must accept the interest rate risk as the *quid pro quo* for maintaining the tax-exempt status of the income earned. Investors who have purchased federal obligations that are the subject of repurchase agreements have provided funds to the federal government for the purpose of financing the national debt just like any other investors. They earn interest on their investment and that interest should be exempt from taxation by the states just as is the interest earned by investors who do not engage in repurchase transactions. There is no rational reason to treat them any differently.

C. The United States Government Also Benefits From Repurchase Agreements.

There is a third party which benefits from repurchase transactions as well. To be able to continue to finance government operations and refinance existing debt, it is

critical to the federal government that it have ready access to the credit markets. To facilitate liquidity, federal obligations are freely transferable and their ownership is tracked in the Federal Reserve's book-entry system. Although it is true that once obligations are issued, it is of no particular concern to the United States Government who holds them, it is nonetheless true that an active secondary market in United States obligations is critical to their liquidity and marketability which directly affect the rate of interest that the federal government must pay to finance the national debt. Obviously, an investor who purchased a thirty-year treasury bond with the knowledge that there was no way to obtain access to the investor's funds throughout the next thirty years would extract a substantially higher return than one purchasing thirty-year bonds with the knowledge that they could readily be traded the next day or anytime during the succeeding thirty-year period should the need arise. Thus, the liquidity provided by the repurchase market in federal obligations serves the interests of both private and public investors as well as the federal government.

D. This Court Should Not Sanction a Unique Characterization of Repurchase Agreements Solely for Tax Purposes.

Petitioner recognizes, as it must, that in myriad other circumstances, courts have recognized that there is no reason to treat the sale of a security pursuant to a repurchase agreement differently than any other sale of a

security.[19] In addition to the bankruptcy and securities law circumstances mentioned by petitioner, repurchase transactions are treated as ordinary sales and purchases of securities in other contexts as well. For example, in determining whether a tax-exempt fund has met the SEC's diversification requirements, a "repurchase agreement shall be deemed to be an acquisition of the underlying securities, provided that the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully." 17 C.F.R. § 270.2a-7(c)(4)(i)(B)(2) (1993). Similarly, the Comptroller of the Currency has ruled that federal bank lending limits do not apply to repurchase transactions involving federal securities. 12 C.F.R. § 32.103 (1994). These regulations simply recognize that an investor who acquires an obligation pursuant to a repurchase agreement has legal title to that obligation and effectively owns the security until the investor carries out the second half of the transaction and reconveys it to the original seller.

Even the petitioner's counsel and other attorneys general have recognized in other contexts that a repurchase agreement is nothing more than a purchase and subsequent sale of securities. State attorneys general have been asked frequently to determine whether state officials require specific authority to engage in repurchase transactions and whether those transactions

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[19] Petitioner's Brief at 22-23, n.10.

violate any state constitutional provisions against lending the credit of the state to a private individual.

Almost thirty years ago, the Attorney General of the State of California was asked to determine whether the State Treasurer was authorized to enter into repurchase agreements. At that time he concluded that "a repurchase agreement in final analysis is nothing more than a purchase and a sale of securities [and] any state investing agency which has authority to purchase and sell securities is endowed with authority to enter into a repurchase agreement." 44 Op. Cal. Att'y Gen. 140, 143 (1964). In so concluding, the Attorney General of California effectively refutes petitioner's principal arguments in this proceeding.

> We cannot see that the entering into an agreement to sell at the same time the state purchases in any way dilutes the state's interest in the property during the period between the original purchase and resale. For all intents and purposes, the state is the owner during this period and if for some reason the repurchase falls through, the state would remain the owner. No proceedings to foreclose or wipe out the title of the seller would be necessary. Likewise, it would seem that the state, after acquiring the securities, though it might subject itself to liability, could pass title to a third party if it chose to ignore its agreement to retransfer to the original seller. However, the risk of loss during the period between the original sale and the repurchase would be upon the state. If a tangible non-negotiable chattel were involved, the power to pass title and the shifting of risk of

loss to the purchaser would indicate the transaction was a sale rather than a bailment. There is no reason why the peculiar nature of the property involved, a negotiable instrument representing an obligation of the United States, should require the transaction to be looked upon as a pledge or something other than a sale.

It is true that from the seller's standpoint the transaction may serve as a substitute for a short-term loan in which the securities would be used as collateral. This, however, is not properly a consideration in determining the legality of the state's participation in the transaction. If there is an actual sale it is immaterial that the seller had a choice as to the manner in which he would attain his object. That he might have accomplished the same thing, that is, obtained the use of money for a certain period by means of a loan, does not make the alternative method by which it is accomplished a loan, and, hence an unauthorized act on the part of the Treasurer. It is accordingly concluded that the Treasurer is authorized to enter into repurchase agreements of the type set forth above.

Id. at 142-43.

Twenty-nine years later, the Attorney General for the State of Nevada reached the same conclusion: "Repurchase agreements are buy-sell transactions that do not violate the constitutional prohibition against the loan of state money." Nev. Att'y Gen. Op. No. 89-3, 1989 Nev. AG LEXIS 3. The Nevada Attorney General based his conclusion, in part, on the following:

> A majority of states provide statutory authorization for the investment of state moneys in repurchase agreements although most of those states, like Nevada, have constitutional prohibitions against the loan of state money or credit. The inference, of course, is that investments and repurchase agreements are not loans which would violate those constitutional prohibitions.

Id. at 5. The Attorney General for the State of West Virginia reached the same conclusion. "[W]e conclude that these agreements are contracts for the resale and repurchase of securities." 1990 W. Va. AG LEXIS 12, at 8.

A very thorough and thoughtful analysis of the issue is contained in Opinion No. 90-34 of the Attorney General of the State of Oklahoma. 1990 Okla. AG LEXIS 26. The Oklahoma Attorney General, after an exhaustive review of the authorities, concluded that "the relevant case law reveals that there is no comprehensive analytical approach which enjoys widespread acceptance and adherence by the courts." *Id.* at 21-22. He then went on to revoke two earlier attorney general opinions that held the use of repurchase agreements violated the Oklahoma Constitution and concluded "that participation in repurchase agreements, like investment in revenue bonds, obligations of the United States and high quality corporate obligations, does not offend the lending of the credit clause of the Oklahoma Constitution." *Id.* at 24.

The Nebraska Attorney General has reached a similar conclusion. Legislative Bill 379, adopted in 1989, and codified at *Neb. Rev. Stat.* § 79-1308.01(2) (1992), specifically authorized school districts to use repurchase agreements to invest their surplus funds. The Nebraska Attorney General was asked to opine whether such repurchase agreements violated Nebraska Constitution

art. XIII, § 3, which provides that the "credit of the state shall never be given or loaned in aid of any individual, association or corporation." The Attorney General of Nebraska concluded that repurchase agreements did not violate this provision.

> [R]epos authorized by LB 379 may be defined as written agreements whereby one party sells "securities" to another party with the understanding that at a future time certain the selling party will repurchase the securities at a stated higher price. It also appears that the only apparent legislative purpose in authorizing school districts to purchase repos is to maximize their return on funds which are not currently required for operational expenses of the school district.
>
> . . . We are therefore of the opinion that the authority granted by LB 379 to school districts to purchase repos does not violate Neb. Const. Art. XIII, § 3, for the reason that the apparent purpose is entirely public: to maximize the return on investment of school funds.

Neb. Att'y Gen. Op. No. 89023, at 2.

Respondent does not suggest that these attorney general opinions are binding upon this Court or even on the various states involved. However, these attorney general opinions do make it clear that even the attorneys general of petitioner and other states, when called upon to look at repurchase agreements outside the taxation arena, have recognized that repurchase agreements are exactly what they purport to be: the purchase of a security combined with a contemporaneous agreement to later resell it at an agreed upon price to the original seller. There is no

reason that this Court should adopt a different approach to these agreements that would be used *solely* in the taxation arena.

III. TREATING REPURCHASE AGREEMENTS AS PURCHASES AND SALES OF SECURITIES WILL NOT RESULT IN ANY "DOUBLE TAX BENEFIT" FOR INTEREST ON FEDERAL OBLIGATIONS.

A. The Challenged Revenue Rule Results in State Taxation of Income From Federal Obligations.

Repurchase agreements do not deprive the states of any revenue to which they would otherwise be entitled. Three hypothetical scenarios involving federal obligations will make this point clear.

1. Taxable federal income.

Since the starting point for the Nebraska income tax is a taxpayer's federal adjusted gross income,[20] any discussion of a Nebraska income tax on income from federal obligations must begin with a review of the applicable federal tax laws. For the purposes of this discussion, we will use the following hypothetical. On January 3, 1994 Taxpayer 1 purchases a 360-day, $10,000 treasury bill at original issue for $9,500.[21] This treasury bill matures on December 29, 1994 at which time the United States Treasury will pay the holder of the obligation $10,000. At that

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[20] *Neb. Rev. Stat.* § 77-2714.01(1) (1990).

[21] *See supra*, note 1, for an explanation of the process of auctioning treasury bills.

point, the actual cost to the United States Treasury for the use of the $9,500 for the year 1994 is $500.[22] If Taxpayer 1 holds this treasury bill to maturity, Taxpayer 1 will have $500 in taxable interest income at the federal level.[23]

2. Nebraska Adjustments to Federal Income.

If Taxpayer 1 were a Nebraska taxpayer, Taxpayer 1 would begin calculating his Nebraska income tax by using his federal adjusted gross income which would include the $500 in interest income on the United States treasury bill. However, he would then be entitled, at the state level, to further adjust his federal adjusted gross income by reducing it by $500, the amount received from the United States Government.[24] It is thus clear that

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[22] Redemption price at maturity ($10,000) minus issue price ($9,500) equals U.S. Treasury interest cost ($500).

[23] "In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable;. . . . " Treas. Reg. § 1.61-7(b)(3). "When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law." Treas. Reg. § 1.61-7(c).

[24] There shall be subtracted [from federal adjusted gross income] interest or dividends received by the owner of obligations of the United States and its territories and possessions or of any authority, commission or instrumentality of the United States to the extent includable in gross income for federal income tax purposes but exempt from state income taxes under the laws of the United States.

Neb. Rev. Stat. § 77-2716(1)(a) (1990).

Taxpayer 1 would pay no Nebraska income tax on the $500 received as income on the treasury bill. 31 U.S.C. § 3124 (1988).

3. Analysis Involving Two Taxpayers.

The result is the same ($500 in total taxable income at the federal level, $0 in taxable income at the state level) when two Nebraska taxpayers are involved in the transaction instead of one. Assume that after holding the treasury bill for 180 days, Taxpayer 1 transfers it to Taxpayer 2, another Nebraskan, for its fair market value on that day of $9,750.[25] At maturity, Taxpayer 2 redeems the treasury bill for $10,000. Taxpayer 1 would have $250 in federal taxable income and Taxpayer 2 would also have $250 in federal taxable income.[26] Each of these Nebraska taxpayers would be entitled to reduce their federal adjusted gross income by $250, the amount of federal interest income they received, resulting in net taxable Nebraska income of $0. Note that Taxpayer 1 has $250 in tax-exempt income without ever receiving a check from the United States Treasury. The Internal Revenue Code and the regulations adopted under it require that Taxpayer 1 report that income as federal interest income and that characterization flows through to the taxpayer's Nebraska Income Tax Return because of Nebraska's wholesale adoption of federal tax law. *See Neb. Rev. Stat.* § 77-2714 (1990).

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[25] This assumes that interest rates have remained constant throughout the year. If rates changed, the exact dollar amounts allocated to Taxpayers 1 and 2 would be different, but total interest would remain $500.

[26] *See* I.R.C. § 1276; Treas. Reg. § 1.61-7.

These two hypotheticals demonstrate the following principles. First, the total amount of interest to be paid by the federal government is determined at the time that a treasury bill is issued although the interest is actually paid at the bill's maturity. Second, the total amount of interest paid by the federal government may be distributed among one or more taxpayers even though only one taxpayer receives a check from the federal government. Third, the sum of all federally taxable interest received by taxpayers must equal the amount of interest paid by the federal government. Fourth, the total amount of income exempt from state taxation must equal the amount of interest paid by the federal government.

4. Analysis Involving Repurchase Agreements.

It is this fourth and final principle which the petitioner seeks to avoid in violation of 31 U.S.C. § 3124 (1988). The fact that various taxpayers have entered into repurchase agreements throughout the year involving a federal obligation should not change the analysis or the net result for purposes of state taxation. Assume, for purposes of a third hypothetical, that after 180 days Taxpayer 1 again sells the treasury bill to Taxpayer 2 for $9,750. However, this time the agreement provides that Taxpayer 1 has the right and the obligation to repurchase the treasury bill on December 29, 1994 for the original purchase price of $9,750 plus $250 "interest." Assume further that on December 29, 1994 Taxpayer 1 repurchases the treasury bill as agreed for $10,000 and then redeems it for $10,000. Taxpayer 1 clearly has federal adjusted gross

income of $250.[27] Taxpayer 1 is then entitled under Nebraska law to exclude this $250 from his Nebraska adjusted gross income, making it $0, because it was derived from a federal obligation.[28]

Taxpayer 2 also has $250 in federal adjusted gross income as a result of the transaction. It is this portion of

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[27] The result is the same whether calculated in terms of gain on the sale of the security earned at the time the repurchase agreement is entered into ($9,750.00 - $9,500.00 = $250.00) or whether looked at in terms of net interest earned when the security is redeemed at maturity ($10,000.00 redemption price less $9,500.00 purchase price less $250.00 deductible interest cost equals net interest income, $250.00).

[28] Petitioner incorrectly suggests that such a taxpayer would be entitled to reduce his federal adjusted gross income by $500. Petitioner's Brief at 19-20, n.8. If this were the case, the taxpayer, who earned only $250 on the transaction, could exclude the $250 earned from his Nebraska taxable income and also "shelter" another $250 from some other source, a true case of abuse of tax-exempt obligations. To prevent such a result, Nebraska law requires that the taxpayer net his interest costs against the income received from the federal obligation.

> Any amount subtracted under this subsection [the federal interest exclusion] shall be reduced by any interest on indebtedness incurred to carry the obligations or securities described in this subsection or the investment in the regulated investment company and by any expenses incurred in the production of interest or dividend income described in this subsection to the extent that such expenses, including amortizable bond premiums, are deductible in determining federal taxable income.

Neb. Rev. Stat. § 77-2716(1)(e)(i) (1993). Thus there is no risk of a "double tax benefit." *See also* discussion of the analogous federal provision, I.R.C. § 265, in the next subsection of this brief.

the tax-exempt interest paid by the federal government that petitioner seeks to tax in violation of 31 U.S.C. § 3124 (1988). Under the fourth principle announced above (total income exempt at the state level must equal total interest paid by the federal government), the $250 earned by Taxpayer 2 must also be exempt from state taxation. Otherwise, even though the federal government had paid $500 in interest exempt from state taxation, only $250 would go untaxed by the State and a portion of the federal exemption would have simply disappeared.

As this series of hypotheticals demonstrates, this case has nothing to do with a "double tax benefit."[29] Nor are the taxpayers trying to transform otherwise taxable income into exempt income to the detriment of the State. Rather, it is clear that petitioner is seeking to erode or, at the limit, wipe out the exemption for income derived from federal obligations established by 31 U.S.C. § 3124 (1988).[30] Petitioner has advanced not a single public

[29] See Petitioner's brief at 19-20, n.8.

[30] In the case of a reverse to maturity (*see* Stigum at 128-30 for an explanation of reverses to maturity and their uses), petitioner would tax **all** of the interest earned by a federal obligation. For example, if Taxpayer 1 purchased a federal obligation at issue for $9,500 and immediately sold it to Taxpayer 2 with the right and obligation to repurchase it 360 days later at maturity for $10,000, Taxpayer 2 would have $500 in Nebraska taxable income under petitioner's view of the law, thus obtaining no tax benefit, while Taxpayer 1 would obtain no tax benefit either since under *Neb. Rev. Stat.* § 77-2716(1)(e)(i) (1993) the interest received from the federal government and the interest paid to hold the obligation would cancel each other out. The net effect in such a situation is that the entire $500 paid by the federal government would be taxed by petitioner.

policy or tax equity reason why income which is clearly not subject to its taxing authority should become taxable in whole or in part because of repurchase transactions entered into by the parties at arm's length for reasons completely unrelated to taxation.

If parties have decided to divide federal interest as would be required by I.R.C. § 1276 and Treasury Regulation § 1.61-7 on the sale of a bond between interest dates, and if the total amount of federal interest reportable remains unchanged, why should the Court seek to revise the transaction from the form it has been cast in by the parties and which all of the financial community understands? Income earned by taxpayers who invest in federal obligations that are the subject of repurchase transactions retains its exempt status and this Court should therefore sustain the Nebraska Supreme Court's decision below invalidating the petitioner's attempt to tax this income.

B. The 1986 Tax Reform Act Eliminated the Rationale for Union Planters.

The holding of the *Union Planters* line of cases does not support the petitioner's contention that "ownership" of federal obligations should be a determining factor for tax purposes.[31] The rule announced in these cases was adopted to fill a statutory lacuna that was subsequently addressed by Congress in the Tax Reform Act of 1986.

[31] *American Nat'l Bank v. United States*, 421 F.2d 442 (5th Cir. 1970); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115 (6th Cir. 1970); *First American Nat'l Bank v. United States*, 467 F.2d 1098 (6th Cir. 1972).

Thus, the rationale of those cases is no longer valid under today's tax laws. It is not merely a coincidence that the taxpayers in all three cases were banks. Those cases were driven by the unique nature of the taxpayers, all of which were banks, not by the nature of repurchase transactions in general. *See Citizens Nat'l Bank v. United States*, 551 F.2d 832, 841 (Ct. Cl. 1977) (refusing to apply rule in an outsider dealer/bank context).

To understand the courts' concern in the *Union Planters* cases, we must begin with I.R.C. § 265. If a taxpayer borrowed money to purchase tax exempt securities and was allowed both to exclude the income on the securities and deduct the interest the taxpayer paid on its borrowing, this "double benefit" would lead to abuse of tax-exempt securities. Accordingly, Congress adopted what is now section 265 which disallows a deduction for interest incurred to finance purchases of tax-exempt securities.[32] In *Denman v. Slayton*, 282 U.S. 514 (1931), this Court upheld the predecessor to section 265 and explained its purpose as follows:

> The manifest purpose of the exception . . . was to prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money.
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> Under the theory of the respondent, "A," with an income of $10,000 arising from non-exempt securities by the simple expedient of

[32] "No deduction shall be allowed for . . . (2) [i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." I.R.C. § 265(a)(2).

> purchasing exempt ones with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility. The classification complained of is not arbitrary, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress.

282 U.S. at 519-20.

The courts in the *Union Planters* cases were concerned about transparent attempts to evade this restriction by bond dealers whose portfolios of municipal bonds the banks were financing. Banks, unlike all other taxpayers, had historically been exempted from the operation of section 265 even though they obviously borrowed funds from their depositors, invested the money in tax-exempt obligations, and took deductions for the interest they paid to their depositors while excluding the interest they received from their taxable income.[33] Thus, the courts in the *Union Planters* cases were presented with atypical situations. The Code, in these particular cases, ceased to function in its normal symmetrical fashion where tax-exempt income resulted in a corresponding denial of a

[33] *See* Rev. Rul. 61-222, 1961-2 C.B. 58.

deduction for interest paid.[34] Therefore, the courts proceeded to restore symmetry to the transactions in the only way available to them. They determined that the tax exempt income would be allocated to the bond dealers who would then be denied an interest deduction under section 265. The income received by the banks would be taxable, although the banks would enjoy an offsetting deduction for the interest they paid their depositors.

Today, however, there is no longer any need to recharacterize the parties' transaction in order to achieve symmetrical treatment under the Code. As part of the Tax Reform Act of 1986, Congress amended section 265 to make it specifically applicable to banks. Pub. L. No. 99-514 § 902 (1986). Moreover, it streamlined the operation of section 265 by doing away with a factual determination in each case of why funds were borrowed and whether they were used to finance the purchase of tax exempt securities or for some other purpose. Instead, Congress adopted a simple pro rata approach for financial institutions that abandoned any attempt to trace or allocate funds.[35] A bank's interest deduction is simply reduced by the portion of its income that is tax-exempt. The concern expressed by the court in *Union Planters* has

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[34] Note also that although *Union Planters* predated this Court's decision in *Frank Lyon Co.*, the requirements of that decision were nonetheless met. There was no valid business or regulatory reason advanced for structuring the transaction in the manner the parties had chosen. Clearly the sole purpose was to evade the strictures of section 265.

[35] "In the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest." I.R.C. § 265(b)(1).

thus been obviated and the symmetrical treatment of exempt income and deductible interest has been restored.

Thus, while the *Union Planters* cases may have been correctly decided under the law at the time, their rationale is no longer viable under present law. Now that banks are subject to the limitations of section 265, there is no danger of a double benefit in repurchase transactions.[36] Therefore the holding of the *Union Planters* cases should not be applied to the repurchase transactions presently before the Court.

IV. THE NEBRASKA TAX ON REPURCHASE AGREEMENT INCOME IS AN UNCONSTITUTIONAL DISCRIMINATORY BURDEN ON FEDERAL BORROWING POWER.

A. States May Not Adopt a Tax Which Discriminates Against Federal Obligations.

Even if this Court were to determine that a state is permitted to tax income derived from federal obligations which are the subject of repurchase agreements, the Nebraska approach to the taxation of such income would violate the constitutional prohibition against discriminatory taxation of federal obligations.[37] In *Memphis Bank &*

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[36] Congress did include a "small issuer" exception that would still allow financial institutions to deduct interest payments on funds used to purchase tax exempt obligations in limited circumstances. I.R.C. § 265(b)(3). However, this Court should not adopt a rule applicable to all repurchase agreements based on this limited exception to the general rule.

[37] Revenue Ruling 22-85-1 dealt specifically and only with federal obligations. There is no comparable Nebraska revenue

Trust Co. v. Garner, 459 U.S. 392 (1983), this Court struck down a similarly discriminatory Tennessee bank tax which included interest from federal obligations, but not interest from Tennessee's own state obligations. This Court held that a "state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." 459 U.S. 397. The Court then went on to hold that the Tennessee tax scheme was unconstitutional.

> It is clear that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory under § 742 [now 31 U.S.C. § 3124]. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals.

459 U.S. at 398-99.

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ruling that makes interest income on state obligations which are the subject of repurchase agreements taxable at the state level. Nor do Nebraska statutes require that income earned on Nebraska obligations, which would be excluded from federal adjusted gross income, be added in to determine Nebraska taxable income. *Neb. Rev. Stat.* § 77-2716(1)(b) (1993). Nebraska tax law, therefore, clearly discriminates against income earned from federal obligations which are the subject of repurchase agreements.

This Court applied the same principle in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989), concluding that it was unconstitutional for the State of Michigan to exempt from taxation retirement benefits paid by the state to its employees, but to tax the retirement benefits paid by all other employers including the federal government. The Court found there were no "significant differences" between the two classes of retirees and therefore the Michigan exemption of the retirement benefits which it paid was unconstitutional. 489 U.S. at 816-17. In so doing, the Court stated that "[t]his result is consistent with the underlying rationale for the doctrine of intergovernmental tax immunity. The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it." 489 U.S. at 816, n.4. *Accord Barker v. Kansas*, 112 S. Ct. 1619 (1992) (state of Kansas could not constitutionally tax U.S. military retirement benefits while not taxing state and local government retirement benefits). These comments are particularly applicable to the present case. Nebraska Revenue Ruling 22-85-1 results in taxation of the earnings from federal obligations which are subject to repurchase agreements while neither this revenue ruling nor any other imposes such a burden upon state obligations which are subject to repurchase agreements. Just as the Tennessee, Michigan and Kansas taxes were unconstitutional, this Nebraska Revenue Ruling is also unconstitutional.

B. Taxation of Income From Repurchase Agreements Would Adversely Affect the Borrowing Ability of the United States.

The intergovernmental tax immunity doctrine "is based on the proposition that the borrowing power is an essential aspect of the Federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 190 (1987). The constitutional test in this case is whether imposition of the Nebraska income tax will place a burden, however slight, upon federal obligations which is not borne by obligations issued by the State of Nebraska.

Undisputed expert testimony makes it clear that a Nebraska income tax on federal obligations which are subject to repurchase agreements will make it more difficult and expensive for the federal government to finance the national debt and such a tax is therefore invalid. Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (J.A. 25-26), testified that repurchase agreements play a substantial and important role in the market for United States Government securities, and therefore are also extremely important in the process of financing the national debt. (J.A. 28-29).[38]

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[38] As this Court noted in construing a predecessor to 31 U.S.C. § 3124 (1988), the purpose of the exception is to protect from state taxation "the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." *Smith v. Davis*, 323 U.S. 111, 119 (1944).

Upon issuance of new government securities, the Federal Reserve distributes the securities to a limited number of "primary dealers" who then act as market-makers for the securities (J.A. 41-42, ¶ 6). The primary dealers, selected and approved by the Federal Reserve, then sell the federal securities to "secondary dealers," such as savings and loan associations, money market and mutual funds, insurance, financial, and other corporate investors. Secondary dealers, in turn, provide access to investment in the government securities to the public through a variety of mechanisms. In the context of this case, the mutual funds are secondary dealers.

Given the current large national debt, vast amounts of United States Government securities are issued from time to time. Repurchase agreements provide a financing function allowing dissemination of this huge quantity of debt to the investing public. Federal Reserve operations in the market on a single day through repurchase agreements frequently amount to more than $3 to $4 billion, and have reached as high as $7.9 billion (J.A. 40-41, ¶ 3).

Sternlight concluded: "The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets." (J.A. 40, ¶ 3). The underwriting function for United States Treasury issues performed by "primary dealers" would be impaired by the inability to characterize repurchase transactions as sales transactions. Impairment of the repurchase market "would make it less attractive

for dealers to perform this very useful underwriting function, *thus adding to Treasury interest costs.*" (J.A. 41-42, ¶ 6, emphasis added).

The undisputed expert testimony before the courts below clearly establishes that state taxation of repurchase transactions would "add . . . to Treasury interest costs." This Court has consistently held that such a discriminatory burden on federal obligations is impermissible. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). Therefore, the Nebraska Supreme Court correctly concluded, based upon the factual record before it, that the revenue ruling at issue contravened the U.S. Constitution and 31 U.S.C. § 3124 (1988).

CONCLUSION

For almost 150 years this Court labored to define the limits of intergovernmental tax immunity. It typically resolved individual cases by employing an arbitrary semantic test which this Court itself recognized was based on the "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests [which] was 'firmly embedded in the law.' " *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858. Then, in 1959, Congress amended the applicable statute, ultimately codified as 31 U.S.C. § 3124, and adopted a "sweeping" exemption for income derived from federal obligations in any way. 463 U.S. at 862. It is this exempt income which petitioner seeks to tax in this case.

Petitioner urges that this result be reached by returning to the discredited semantic approach employed before 1959. And it suggests that the semantic test to be employed is whether the taxpayer was the "owner" of federal obligations, a word conspicuously absent from the text of the controlling statute. In the ultimate irony, it urges that this result is compelled by the "economic reality" of the transaction at issue when it is clear that the real effect of the rule argued for by the petitioner would be to impose a state tax on interest income from federal obligations just as surely as if the Legislature of the State of Nebraska had explicitly announced its intention to ignore the dictates of 31 U.S.C. § 3124 and the Supremacy Clause and tax the income of its citizens earned through investing in federal obligations. The Nebraska Supreme Court correctly determined that the actions of the petitioner violated 31 U.S.C. § 3124 and this Court should sustain that decision.

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